



Economic Update

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Economy Surges, Payroll Jobs Increase

The U.S. economy grew at its fastest pace in nearly 20 years over the summer, as tax relief helped boost consumer spending and business investment. The labor market also showed benefits from the stronger economy: payroll employment rose for 3 consecutive months, and the unemployment rate continued its downward trend.

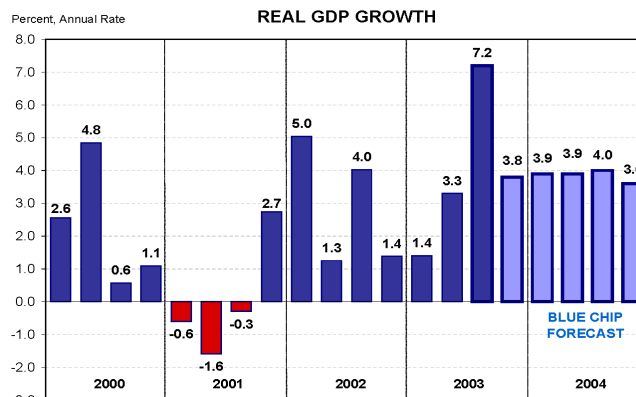
With the accumulating positive evidence, private forecasters have boosted their projections for growth in real gross domestic product [GDP] over the coming year. Federal Reserve Chairman Greenspan also recently cited the improved economic outlook and the likelihood of “a revival in job creation,” and he urged fiscal discipline focused on spending restraint.

Evidence of Solid Economic Expansion

The U.S. economy appears to have shifted into a higher growth phase of the economic expansion, following the economic slowdown and recession of 2000-01 and the uneven recovery that extended into early 2003.

Real GDP Growth: Real GDP grew at a 7.2-percent annual rate in the third quarter – the strongest growth in nearly 20 years. With the 3.3-percent rate of growth in the second quarter, the economy produced two consecutive quarters of real GDP growth at or above its “potential” rate of increase (that is, the highest rate of real GDP growth that can persist for a sustained period without raising inflation), which the Congressional Budget Office estimates at around 3 percent.

- *Real consumer spending* rose at a 6.6-percent annual rate in the third quarter, the strongest quarterly growth in consumer spending in 6 years. About two-thirds of the consumption surge is attributable to the tax relief from the lower withholding rates and the advance payment of child tax credits of the Jobs and Growth Tax Relief Reconciliation Act of 2003.
- *Real fixed business investment* rose at an 11.1-percent annual rate in the third quarter, its largest increase since



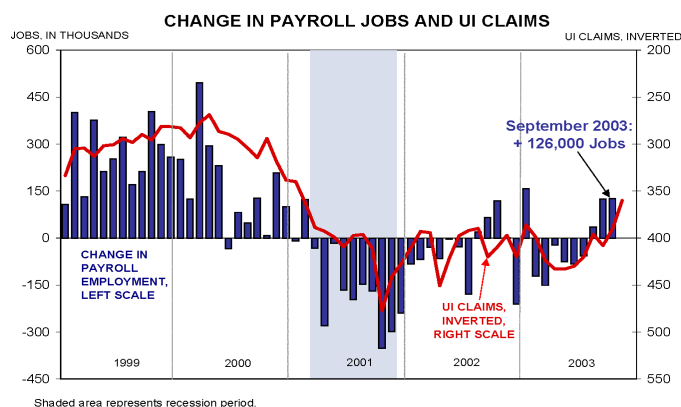
the beginning of 2000. Business spending on equipment and software – aided by the “bonus depreciation” tax incentives passed by Congress last year and extended earlier this year – rose at a 15.4-percent annual rate (also the largest increase since early 2000). Even so, business construction spending, which tends to lag in economic recoveries, has been flat over the past year.

- *Real residential investment* continued its climb to new historical highs, rising at a 20.4-percent annual rate in the third quarter. Housing starts and building permits also continued at high rates.
- *Real business inventories* declined at a \$36-billion annual pace, as the strong spending growth outpaced production. The inventory effect subtracted 0.7 percentage point from the real GDP growth rate. The inventory decline may foreshadow future output gains, however, as businesses increase production to meet growing demand and to rebuild inventories. The Blue Chip consensus expects inventory increases to add 0.8 percentage point to real GDP growth over the next year.

The combination of higher government spending and an unexpected decline in the U.S. trade deficit contributed about a percentage point to the GDP growth rate. A return to

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a higher trade deficit in coming quarters, however, would subtract somewhat from future real GDP growth.



Labor Markets: Payroll employment rose by 126,000 jobs in October. The increase, coupled with upward revisions to prior months brought the August-to-October gain to 286,000 jobs – the largest 3-month gain in 3 years. Unemployment insurance claims fell sharply at the end of October, and are at their lowest levels since January 2001 – a good sign for future job gains (see chart above). The unemployment rate continued to trend down from its recent high of 6.4 percent in June, falling to 6.0 percent in October.

Other Key Indicators: The manufacturing sector is improving, with increases in industrial production, the Institute for Supply Management’s [ISM’s] manufacturing index, and new orders and shipments of manufacturers’ durable goods. The ISM nonmanufacturing activity index also continues at high levels. Consumer sentiment and confidence rose in October, and are up significantly from the lows of earlier this year.

The Blue Chip Outlook

Reflecting the evidence of a stronger economy, the Blue Chip forecast for real GDP growth through the end of 2004 increased this month. November’s survey projects real GDP growth of 3.9 percent during 2004 (fourth quarter 2003 to fourth quarter 2004), up from the 3.7 percent in October’s survey. Similarly, the November survey now shows a projected decline in the unemployment rate to 5.7 percent by the fourth quarter of next year; last month’s survey had shown 5.8 percent. (Note that the November Blue Chip survey was conducted prior to the release of the October employment report.)

Even though the outlook for real GDP growth has improved, the projected levels of interest rates and inflation remain at relatively low levels. Still, the Blue Chip forecasters expect interest rates to start rising next year, with a majority expecting the Fed to raise rates prior to July 2004.

Although risks remain for the outlook, forecasters generally expect – barring unforeseen shocks – that the economy and labor markets will show continued significant gains over the coming year.

Fed Chairman Greenspan on the Economy and the Federal Budget

In a recent speech, Fed Chairman Greenspan sounded noticeably upbeat about the “relatively optimistic short-term outlook for the U.S. economy.” Greenspan said: “Economic activity perked up . . . as tax cuts provided a substantial boost to the disposable incomes of households” and that “the odds . . . do increasingly favor a revival in job creation.” [For more on the “odds” for jobs growth, see “Stronger Economy – And Payroll Jobs Growth – Expected Through 2004,” *Budget & Economic Monitor*, Volume 1, Number 1, 29 October 2003.] Greenspan stated that, despite the outlook for stronger growth, “monetary policy is able to be more patient” in the current low-inflation environment.

Chairman Greenspan also cited “growing longer-term concern in financial markets about our Federal budget.” As to how to resolve the budget imbalances, Greenspan said: “Tax rate increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risks to economic growth and the revenue base” and that “such risks . . . warrant aiming to close the fiscal gap primarily, if not wholly, from outlay restraint.”

Blue Chip Economic Outlook, November 2003

	2003.1	2003.2	2003.3	2003.4	2004.1	2004.2	2004.3	2004.4
	History				Projection			
Real GDP Growth	1.4	3.3	7.2	3.8	3.9	3.9	4.0	3.6
Unemployment Rate	5.8	6.2	6.1	6.1	6.0	5.9	5.8	5.7
CPI Inflation	3.8	0.7	2.4	1.8	1.8	1.8	2.0	2.1
3-month Treasury Bill	1.2	1.0	1.0	1.0	1.1	1.2	1.5	1.8
10-year Treasury Note	3.9	3.6	4.3	4.3	4.5	4.7	4.8	5.0

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